ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Polanco | Analyst: Marion Mann DeJong | Bill Number: SB 1125

Related Bills: AB 1218 (1997/98) | Telephone: 845-6979 | Introduced Date: 02/26/1999

Attorney: Doug Bramhall | Sponsor:

SUBJECT: B&CT Deduction/Interest Expense/Insurance Companies

SUMMARY

This bill would do the following:

- Allow corporations to deduct interest expense attributable to dividends that are received from an insurance company subsidiary and are excluded from income.
- Specify that Section 24425 (which denies a deduction for expenses relating to the production of income that is not included in the measure of California tax) would not apply to expenses related to deductible dividends received from insurance companies.
- Remove the commercial domicile restriction from Section 24410, thereby permitting all corporations, regardless of commercial domicile, to deduct dividends received from an insurance company subsidiary.
- Declare legislative intent that the changes made by the bill should not be construed to have any effect on the interpretation or application of Sections 24344, 24410 and 24425 prior to the effective date of the bill.

EFFECTIVE DATE

As a tax levy, this bill would become effective immediately upon enactment and would apply to income years beginning on or after January 1, 1999.

BACKGROUND

Insurance companies in California are taxed by levying a flat percentage tax (2.35%) on their gross written premiums, with certain deductions. This tax is imposed under Article XIII, Section 28 of the California Constitution and is intended generally to be “in lieu of” all other taxes or methods of taxation. Thus, a corporation engaged in the insurance business is not subject to the Bank and Corporation Tax Law and is not included in a unitary group’s combined report.

Many insurance companies have adopted a structure in which the parent corporation (which is subject to the Bank and Corporation Tax Law) is a holding company with an insurance company subsidiary. One advantage of this structure is that the parent holding company can borrow and invest where the insurance company subsidiary is prohibited for regulatory reasons.

Board Position:

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Department Director: **Gerald Goldberg** | Date: **4/1/1999**

To prevent double taxation (gross premiums tax on the insurance company subsidiary and taxable dividends to the corporate parent), a dividend deduction was enacted in the Bank and Corporation Tax Law, to the extent the dividends arose form activities in California.

SPECIFIC FINDINGS

Federal law allows a deduction from gross income for dividends received from a domestic corporation that is subject to income tax. This deduction is limited by stock ownership. One hundred percent of the deduction is allowed when received from a corporation that is a member of the same affiliated group (generally, 80% or more common ownership); 80% of the deduction is allowed when received from a corporation which is at least 20% but less than 80% owned; and 70% of the deduction is allowed when received from a corporation less than 20% owned. The percentage owned refers to the percentage of stock, by vote and value, owned by the recipient corporation. Preferred stock is not considered in determining the percentage of stock owned. In addition, 100% of the deduction is allowed for dividends received by a small business investment company.

The total dividend deduction cannot exceed 70% (80% in the case of a 20% owned corporation) of the recipient corporation’s recomputed taxable income. When recomputing taxable income, any net operating loss deduction, dividend received deduction, capital loss carryback and certain special deductions are not allowed.

Federal law generally allows a deduction for interest paid or accrued during the income year on a corporation’s indebtedness. However, that deduction is disallowed to the extent attributable to the production of exempt income.

Current Bank and Corporation Tax Law (B&CTL) provides for the use of an apportionment formula when assigning *business* income of multistate and multinational corporations to California for tax purposes. For most corporations, this formula is the average of the factors of property, payroll and double-weighted sales applied against worldwide income. Each factor is the ratio of in-state activity to worldwide activity. *Nonbusiness* income from intangible property is generally allocated to the taxpayer’s commercial domicile. *Nonbusiness* income from tangible property is generally allocated to the physical location of the property.

California Regulation Section 25120(c)(4) applies transactional/functional tests to determine the classification of dividend income as business or nonbusiness income. Under these tests, dividends are *business income* when (1) the stock was acquired in the regular course of the taxpayer's trade or business operations, or (2) the purpose for acquiring and holding the stock is related to or incidental to the trade or business operations.

Thus, dividends are *business income* when the stock from which those dividends are derived is held in the ordinary course of business, such as by a stockbroker. Generally, dividends will also be *business income* if they are derived from stock held as current assets or excess working capital. More recently, dividends have been considered to be *business income* when the stock is held for a purpose which furthers the unitary business operations, such as when stock of a supplier is held in order to ensure a steady source of raw materials (Appeal of Standard Oil Company of California, Cal. St. Bd. of Equal., March 2, 1983).

Generally, dividends are *nonbusiness income* when the stock is held as an investment unrelated to the taxpayer's trade or business activities. **The B&CTL** (Section 25126) provides that *nonbusiness* dividend income is allocated to the taxpayer's commercial domicile.

The B&CTL (Section 24402) excludes from taxable income a portion of any dividends received in taxable years beginning after 1989 that are paid out of income that was subject to either the franchise tax, the alternative minimum tax or the corporation income tax in the hands of the paying corporation. The intent of this law is to avoid double taxation of corporate income at the corporate level. The exclusion is in the form of a deduction from gross income. For the recipient corporation to claim such a deduction, the paying corporation must have had income from sources in California that required the filing of a California income or franchise tax return. The Franchise Tax Board makes a computation each year, after the returns are filed, to determine the percentage of dividends paid during the year which are deductible by recipient corporations. In making this computation, a formula is used, allocating within and without the state certain items, such as federal income tax, which affect earnings and profits but which do not affect the income taxable for California tax purposes.

Once California deductible dividends have been computed, the deduction is further limited in a manner similar to the federal stock ownership rules. One hundred percent of the computed deduction is allowed when received from a corporation more than 50% owned by the recipient; 80% of the computed deduction is allowed when received from a corporation which is at least 20% but less than 50% owned; and 70% of the computed deduction is allowed when received from a corporation less than 20% owned.

Under the B&CTL (Section 24410), corporations *commercially domiciled in California* are permitted to deduct dividends received from an insurance company subsidiary operating in California and subject to the gross premiums tax, provided at least 80% of each class of stock of the insurance company is owned by the parent corporation. The deduction is based on the portion of the dividend attributable to California sources, determined by applying a special three-factor formula.

The rationale for Section 24410 is to provide similar relief from double taxation as is provided to general corporations under the dividends received deduction of Section 24402. Section 24410 essentially determines the hypothetical income that would have been properly imposed on an insurance company if it were in fact subject to the franchise tax, and treats the gross premiums tax as having been imposed on that income.

When Section 24410 was enacted (Stats. 1968, Ch. 1379), essentially all dividends were thought to be nonbusiness income unless receipt of dividends was the taxpayer's principal trade or business (i.e., dealers in stocks and securities). This theory was based on pre-Uniform Division of Income for Tax Purposes Act (UDITPA) case law that held the source of the dividend income was the shares of stock and the situs of such stock was traditionally the commercial domicile of the investing corporation (Southern Pacific Co. v. McColgan, 68 Cal. App. 2d 48 (1945)). Earlier versions of California regulation Section 25120(c)(4) reflected this theory.

Subsequently, California case law held that dividends could be business income if the dividends met the transactional/functional tests implicit in Section 25120, and that the (former) FTB regulations were invalid because they were contrary to those statutory tests (Appeal of Standard Oil Company of California, supra.). The Franchise Tax Board amended Regulation Section 25120(c)(4) to apply transactional/functional tests to determine the classification of dividend income as business or nonbusiness income.

Because dividends can be treated as business income, the commercial domicile restriction in Section 24410 operates as a preferential treatment only for California commercially domiciled corporations. Recent court decisions have found similar laws to be facially discriminatory against interstate commerce, without legitimate local purpose, and thus unconstitutional (e.g., Camps Newfound/Owatonna, Inc. v. Town of Harrison, Maine (1997) 520 U.S. 564, 137 L. Ed. 2d 852). Thus, it is likely that Section 24410 would be found unconstitutional, to the extent the deduction is allowed only to a California domiciled corporation, as discriminatory against interstate commerce.

The B&CTL generally provides a deduction for all interest paid or accrued on business debts. However, California restricts interest expense deductions of corporations subject to allocation and apportionment, when their total interest expenses, less expenses deducted in arriving at net nonbusiness income, exceed business (apportionable) interest income. Deductible interest attributable to nonbusiness income includes interest, deductible for federal purposes, incurred for foreign investment, which may be offset against deductible dividends (under Section 24111). The purpose of the “interest offset” is to limit interest expense deductions attributable to the production of nonbusiness income not included in the measure of the California tax.

The B&CTL (Section 24425) denies a deduction for all expenses, including interest expense, relating to the production of income that are not included in the measure of California tax.

Article III, Section 3.5 of the California Constitution provides that an administrative agency does not have the power to declare a statute unenforceable, or refuse to enforce a statute on the basis that federal law or federal regulations prohibit the enforcement of such statute, unless an appellate court has made a determination that the enforcement of such statute is prohibited by federal law or federal regulations.

This bill would allow corporations to deduct interest expense attributable to dividends received from an insurance company subsidiary which are excluded from income (pursuant to the dividends received deduction of Section 24410).

This bill would specify that Section 24425 would not apply to any expenses, not just interest expenses, related to deductible dividends that a corporation received from an insurance company subsidiary.

This bill also would remove the commercial domicile restriction from Section 24410. Thus, all corporations, regardless of where commercially domiciled, would be permitted to deduct dividends received from an insurance company subsidiary.

Finally, **this bill** would make minor technical changes to Section 24410 and declare legislative intent that the changes made by the bill should not be construed to have any effect on the interpretation or application of Sections 24344, 24410 and 24425 prior to the effective date of the bill.

Policy Considerations

This bill would raise the following policy considerations:

- This bill would allow a deduction for expenses attributable to income that is not taxed, providing a double benefit, which is inconsistent with longstanding tax policy.

- Proponents argue that holding companies should be allowed to invest in their subsidiary insurance companies and receive tax deductible dividends from the subsidiaries without having to reduce the deduction for interest incurred in borrowing the invested funds because the dividends paid by the subsidiaries have already been “taxed” under the insurance gross premiums tax.

- Currently, with respect to any holding company receiving deductible dividends from a non-unitary subsidiary in any line of business, the interest deduction of the holding company is subject to interest offset and section 24425 deduction limitation rules. Thus, this bill would place holding companies with insurance subsidiaries in a more favorable tax position than general corporations.

- There does not appear to be specific tax policy to support relief from double corporate taxation only for California domiciled holders of insurance stock. Further, the objective of Section 24410 appears to be the same as the objective of Section 24402: to provide relief from double taxation. The commercial domicile restriction of Section 24410 was probably included because, at the time of enactment, such dividends were generally thought to be nonbusiness income, allocated to commercial domicile. By removing the commercial domicile restriction from Section 24410, this bill would make the tax policy of Section 24410 consistent with Section 24402.

Implementation Considerations

Since the removal of the commercial domicile restriction from Section 24410 would apply only for years beginning on or after January 1, 1999, the department would be required by the state’s Constitution to enforce the restriction for prior years unless and until an appellate court declares California law to be in violation of federal law. This problem could be addressed by applying the amendment to Section 24410 retroactively to all open years.

Implementation of this bill would occur during the department’s normal annual system update.

FISCAL IMPACT

Departmental Costs

This bill would not significantly impact the department's costs.

Tax Revenue Estimate

This bill would result in unknown revenue losses annually (beginning January 1, 1999) that cannot be quantified due to data limitations. The expense deduction component, however, is expected to reduce revenues by $1 million annually (see below).

Tax Revenue Discussion

Sufficient data do not exist to estimate the magnitude of losses resulting from removing the commercial domicile restriction from Section 24410 dividends. Even without this bill, revenue losses are likely as the result of cases testing the constitutionality of the statute under which only commercially domiciled corporations are allowed the partial dividend deduction.

Removing the expense deduction limitation for insurance company dividends would result in revenue losses of $1 million annually. Expenses directly traceable or allocated to income not included in the measure of tax (dividends deducted under Section 24410) would determine the revenue impact of removing the expense deduction limitation.

Focusing on two groups of taxpayers developed the estimate: (1) those for which audit assessments have been issued for either not allocating expenses or using an unreasonable method for allocating expenses to this class of income, and (2) those that are assumed to voluntarily comply with existing expense limitations. The number of assessments has been sufficiently limited to conclude that revenue losses from foregone future assessments would be minor, probably less than $500,000 annually. If revenue losses from the group complying would be roughly equal to the group assessed, an additional $500,000 of losses would occur (total impact on the order of $1 million annually).

BOARD POSITION

Pending.